

REPORT OF EXAMINATION
OF THE
HERITAGE INDEMNITY COMPANY

AS OF
DECEMBER 31, 2006

Participating State
and Zone:

California

Filed June 9, 2008

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Los Angeles, California
February 15, 2008

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Morris Chavez
Secretary, **Zone IV-Western**
Superintendent of Insurance
New Mexico Insurance Division
Santa Fe, New Mexico

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

HERITAGE INDEMNITY COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 7125 West Jefferson Avenue, Suite 200, Lakewood, Colorado 80235. The Company's statutory home office and main administrative office is located at 3100 Thornton Avenue, Burbank, California 91504.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2002. This examination covers the period from January 1, 2003 through December 31, 2006. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an

evaluation of the assets and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: accounts and records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

SUBSEQUENT EVENTS

On December 28, 2007, the California Department of Insurance approved the acquisition of the Company by Wachovia Corporation, a North Carolina Corporation.

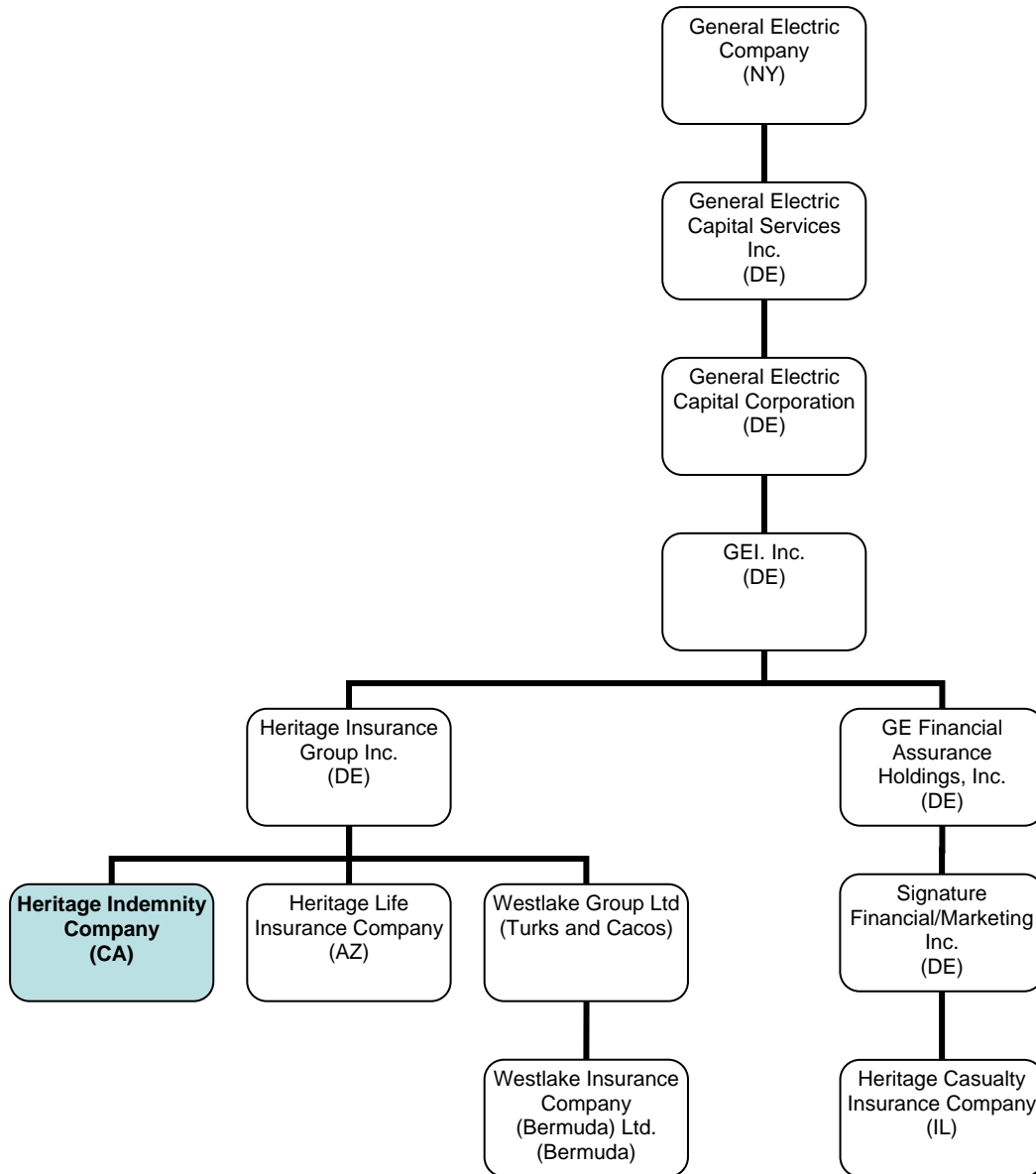
COMPANY HISTORY

The Company is a wholly-owned subsidiary of Heritage Insurance Group, Inc. (HIG), a Delaware corporation. On August 31, 1994, General Electric Capital Corporation (GECC), a New York corporation, acquired all of the outstanding stock of HIG from Quaker State Corporation. GECC is a wholly-owned subsidiary of General Electric Capital Services, Inc., a Delaware corporation, which is ultimately owned by General Electric Company, a New York corporation.

On December 15, 2003, the Company paid dividends of \$60 million to the Heritage Insurance Group, the parent company. The California Department of Insurance approved the payment of this dividend on November 3, 2003.

MANAGEMENT AND CONTROL

The following abridged organizational chart depicts the Company's relationship within the holding company system as of December 31, 2006:



all ownership is 100%

Management of the Company is vested in a seven-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2006 follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Jeffrey J. Adams Littleton, Colorado	Vice President, Risk Management and Assistant Secretary Automobile Warranty Services
Beverly A. Belcamino Stamford, Connecticut	Director Automobile Warranty Services
Jay H. Berman Bryn Mawr, Pennsylvania	Vice President, General Counsel and Secretary Automobile Warranty Services
Jeffrey R. Fleischer Littleton, Colorado	Chief Actuary Automobile Warranty Services
Robert D. Gillespie (*) Lakewood, Colorado	Chief Financial Officer Automobile Warranty Services
Jonathan J. Wilmot Littleton, Colorado	Vice President Automobile Warranty Services
Orlando J. Zayas Denver, Colorado	President and Chief Executive Officer Automobile Warranty Services

Principal Officers

<u>Name</u>	<u>Title</u>
Orlando J. Zayas	President and Chief Executive Officer
Jeffrey J. Adams	Vice President, Risk Management and Assistant Secretary
Marilyn Boretz	Treasurer
Jonathan J. Wilmot	Vice President
Jay H. Berman	Vice President, General Counsel and Secretary

<u>Name</u>	<u>Title</u>
Jeffrey R. Fleischer	Chief Actuary
Jeffrey L. Hyde	Assistant Vice President
John Amato	Assistant Treasurer
Mary Ann Carroll	Assistant Treasurer
Donna M. Fiammetta	Assistant Treasurer
Donald Jaslow	Assistant Treasurer
Kenneth E. Kempson	Assistant Treasurer
Nancy M. Liu	Assistant Treasurer
Robert E. Malitz	Assistant Treasurer
Dianna N. DeWitt	Assistant Secretary
Scott Wolfley (**)	Assistant Secretary

(*) resigned on October 27, 2006 and was replaced by Joseph E. Eikelberner on January 11, 2007.

(**) resigned on August 17, 2007 and was not replaced.

Management Agreements

Services and Shared Expenses Agreement: The Company and Heritage Life Insurance Company, along with additional non-insurance company affiliates, are parties to a Services and Shared Expenses Agreement which became effective on January 27, 1998. The Company and various affiliates agree to provide and accept certain general services provided by any of the affiliates such as actuarial, accounting, data processing, communications, marketing, public relations, advertising, investment management, human resources, legal purchasing, underwriting and claims. Charges for the services are based on actual costs. The Company's share of the common cost is determined based on time and usage. Under the terms of the agreement settlements are made quarterly. Fees paid by the Company for 2003, 2004, 2005, and 2006 were \$2,334,057, \$2,679,385, \$2,676,922, and \$1,348,737, respectively. It was noted that the Services and Shared Expenses Agreement was not submitted to the California Department of Insurance (CDI) for approval per California Insurance Code (CIC) Section 1215.5(b)(4). Therefore, it is recommended that the Company submit the Agreement to the CDI to insure compliance with CIC Section 1215.5(b)(4).

Tax Allocation Agreement: The Company and its parent, Heritage Insurance Group, Inc. (HIG), are parties to a Tax Allocation Agreement, effective May 22, 1998, for the purpose of filing federal income tax returns on a consolidated basis. Under this agreement, the tax allocation is based on the separate return calculation of the parties. Intercompany tax allocations are settled within 30 days from the receipt of the tax refund. It was noted that the Tax Allocation Agreement was not approved by the CDI. Therefore, it is recommended that the Company submit the Agreement to the CDI for approval to ensure compliance with CIC Section 1215.4(b)(3)(H).

Investment Management and Services Agreement: Effective May 1, 2002, the Company entered into an Investment Management and Services Agreement with GE Asset Management Incorporated (GEAM), a Delaware Corporation. Under this agreement, GEAM provides discretionary investment management services to the Company. On a quarterly basis, GEAM charges the Company 8.1 basis points multiplied by one-fourth of the value of the investment managed by GEAM as of the end of each calendar quarter. Fees paid by the Company for 2003, 2004, 2005 and 2006 were \$213,216, \$179,467, \$319,708, and \$340,596, respectively. This Agreement was approved by the CDI on April 30, 2002.

Master Outsourcing Agreement: Effective January 14, 2005, the Company entered into a Master Outsourcing Agreement with GE Capital International Services (GECIS) formed under the laws of India. Under the terms of the agreement, GECIS will provide the Company with data processing, administrative services, actuarial, and accounting services. The Company reimburses GECIS on a monthly basis based on the number of transactions processed during the period. Fees paid by the Company to GECIS for 2005 and 2006 were \$24,161 and \$27,000, respectively. The agreement was approved by the CDI on October 29, 2004.

CORPORATE RECORDS

California Insurance Code (CIC) Section 735 states that the Company must inform the board members of the receipt of the examination report. The board should be informed of the report both in

the form first formally prepared by the examiners and in the form as finally settled and officially filed by the Commissioner. The board must also enter that fact in the board minutes. A review of the board minutes disclosed that, neither the officially filed report nor the formally prepared draft by the examiners was presented to the board. It is recommended that the Company implement procedures to ensue future compliance with CIC Section 735.

TERRITORY AND PLAN OF OPERATION

The Company primarily insures vehicle service contracts administered and marketed by affiliated companies through automobile dealers and original equipment manufacturers throughout the United States. As of December 31, 2006, the Company was licensed in all 50 states and the District of Columbia.

In 2006, the Company wrote \$57.1 million of direct premiums. Of the direct premiums written, \$8.1 million (14.1%) was written in California, \$8.0 million (14%) was written in Minnesota, \$4.4 million (7.6%) was written in Virginia, \$3.8 million (6.7%) was written in New York, \$2.8 million (4.9%) was written in Maryland and \$30.0 million (52.7%) was written in the remaining states.

REINSURANCE

Assumed

The Company has no reinsurance assumed.

Ceded

The Company entered into a 100% quota-share agreement, effective March 1, 1984 and amended on June 12, 1996, with its affiliate, Westlake Insurance Company (Bermuda) Ltd., whereby it cedes vehicle service contract liabilities for certain accounts specified in the agreement. The agreement

was approved by California Department of Insurance on June 18, 1996 in accordance with California Insurance Code Section 1215.5 (c).

As of December 31, 2006, the Company's total reinsurance recoverable for ceded reinsurance totaled \$268,000 or 0.3% of surplus as regards policyholders.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the Year Ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2006

Statement of Financial Condition
as of December 31, 2006

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 167,911,681	\$	\$167,911,681	
Stocks:				
Preferred stocks	13,159,093		13,159,093	
Cash and short-term investments	5,700,278		5,700,278	
Investment income due and accrued	2,458,891		2,458,891	
Reinsurance recoverable from reinsurers	88,604		88,604	
Net deferred tax asset	6,639,644	5,626,575	1,013,069	
Guaranty funds receivable or on deposit	180,580		180,580	
Receivables from parent, subsidiaries and affiliates	9,918,682	2,489,521	7,429,161	
Aggregate write-ins for other than invested assets	<u>796,518</u>	<u>353,335</u>	<u>443,183</u>	
Total assets	<u>\$ 206,853,971</u>	<u>\$ 8,469,431</u>	<u>\$ 198,384,540</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 3,026,795	(1)
Commission payable-contingent commissions			168,450	
Other expenses			(198,327)	(2)
Taxes, licenses and fees			(1,382,844)	(3)
Current federal and foreign income taxes			11,243,107	
Unearned premium			75,126,169	
Ceded reinsurance premiums payable			88,656	
Provision for reinsurance			4,000	
Payable to parent, subsidiaries and affiliates			<u>7,255,674</u>	
Total liabilities			95,331,680	
Common capital stock		\$ 3,025,000		
Gross paid-in and contributed surplus		85,724,090		
Unassigned funds (surplus)		<u>14,303,770</u>		
Surplus as regards policyholders			<u>103,052,860</u>	
Total liabilities, surplus and other funds			<u>\$ 198,384,540</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income

Premiums earned		\$ 37,869,026
Deductions:		
Losses incurred	\$ 23,458,463	
Loss expenses incurred	456,413	
Other underwriting expenses incurred	<u>4,538,290</u>	
Total underwriting deductions		<u>28,453,166</u>
Net underwriting gain		9,415,860

Investment Income

Net investment income earned	\$ 4,047,440	
Net realized capital losses	<u>(42,000)</u>	
Net investment gain		<u>4,005,440</u>
Net income before federal income taxes		13,421,300
Federal income taxes incurred		<u>5,098,803</u>
Net income		<u>\$ 8,322,497</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2005		\$ 90,490,136
Net income	\$ 8,322,497	
Change in net unrealized capital losses	(75,106)	
Change in net deferred income tax	729,021	
Change in nonadmitted assets	2,162,603	
Change in provision for reinsurance	(4,000)	
Aggregate write-ins for gains in surplus	<u>1,427,709</u>	
Change in surplus as regards policyholders		<u>12,562,724</u>
Surplus as regards policyholders, December 31, 2006		<u>\$ 103,052,860</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2006

Surplus as regards policyholders, December 31, 2002, per Examination			\$ 124,055,183
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$44,338,549	\$	
Net unrealized capital gains	1,478,719		
Change in deferred income tax	2,346,154		
Change in nonadmitted assets		5,992,070	
Change in provision for reinsurance	261,073		
Dividends to stockholders		60,000,000	
Aggregate write-ins for gains losses in surplus	<u> </u>	<u>3,434,748</u>	
Totals	<u>\$ 48,424,495</u>	<u>\$ 69,426,818</u>	
Net decrease in surplus as regards policyholders for the examination			<u>(21,002,323)</u>
Surplus as regards policyholders, December 31, 2006, per Examination			<u>\$ 103,052,860</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses

A Casualty Actuary from the California Department of Insurance reviewed the Company's actuarial workpapers with regards to losses and loss adjustment expense reserves. Based on the review, the Company's reserves as of December 31, 2006 for losses and loss adjustment expenses appear reasonable and have been accepted for purposes of this examination.

The Company reported the loss adjustment expenses reserve as a component of the total loss reserve. This was not in compliance with paragraph 5c of Statements of Statutory Accounting Principals (SSAP) No.55 which defines loss adjustment expenses as the expected payments for costs to be incurred in connection with the adjustment and recording of losses. It can be classified into two broad categories as Defense and Cost Containment and Adjusting and Other. It is recommended that the Company report loss adjustment expenses reserve separately from the loss reserve to ensure compliance with SSAP No. 55.

(2) Other Expenses

The debit balance of \$198,327 is the result of a timing difference between an investment sold and cash received that was booked in the Company's suspense accounts. The account balance was reversed in 2007.

(3) Taxes, Licenses and Fees

The debit balance of \$1,382,844 was the result of the Company's overpayment of \$1,678,732 to its parent, Heritage Insurance Group, Inc., for state income taxes, and a credit balance of \$295,888 payable for premium taxes. The Company settled the state income tax overpayment with its parent during 2007.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Management Agreements – Services and Shared Expenses Agreement (Page 5): It is recommended that the Company submit the Service and Shared Expenses Agreement to the California Department of Insurance (CDI) to insure compliance with California Insurance Code (CIC) Section 1215.5(b)(4).

Management and Control – Management Agreements – Tax Allocation Agreement (Page 6): It is recommended that the Company submit its Tax Allocation Agreement to the CDI for approval to ensure compliance with CIC Section 1215.4(b)(3).

Corporate Records (Page 6): It is recommended that the Company implement procedures to ensure future compliance with CIC Section 735.

Losses (Page 12): It is recommended that the Company report the reserves for loss adjustment expenses separately from the loss reserve to ensure compliance with Statements of Statutory Accounting Principal No. 55.

Previous Report of Examination

Fidelity Bonds and Other Insurance (Page 9): It was recommended that the Company obtain and maintain documentation of adequate fidelity bond and additional insurance coverage in accordance with National Association of Insurance Commissioner Recommendations. The Company has implemented the recommendation.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

_____/S/_____
Millie Cao, CFE
Examiner-In-Charge
Associate Insurance Examiner
Department of Insurance
State of California